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The Long Road Back to Balance:

Federal Fiscal Policy Following the April 1989 Budget

by

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Introduction

Focus on the Deficit and the Debt

The issue of Canada's federal deficit and growing public debt, so prominent in the run-up to the April 1989 budget, seems now to have moved back to its familiar place: the back burner. But the lack of public attention does not diminish the seriousness of the problem. The federal net public debt continues to mount at an average rate of over $80 million a day, taking its toll on Canadians' present and future standards of living by committing a growing portion of the government's budget to interest payments, by diverting saving to current consumption, with adverse effects on capital investment and foreign indebtedness, and by adding to inflationary pressure in the economy.[1]

In the April budget, the issue of the persistent federal fiscal imbalance was put front and center, and with good reason. Debt-service costs were forecast to amount to $39.4 billion — $1,500 per Canadian — in the current fiscal year (April 1, 1989 to March 31, 1990), $6.4 billion more than was forecast in the February 1988 budget, and higher than most observers had expected. It is largely because of this development that — despite the fact that revenues for the year are now forecast to be more than $6 billion higher than anticipated in the previous budget — the target for the deficit has also been raised, to $30.5 billion from the previous figure of $28.6 billion. This year, the federal government expects to allocate almost 2 of every 7 dollars it spends to debt service, a burden that has doubled in the past 11 years.

This *Fiscal Policy Monitor* examines the outlook for federal fiscal policy, with particular emphasis on the deficit and the debt, in the wake of the April 1989 budget. It evaluates the budget provisions and the government's five-year plan for expenditures

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Table 1

Projections for the Deficit and the Debt-to-GDP Ratio, fiscal years 1989/90 to 1993/94

	1989/90	1990/91	1991/92	1992/93	1993/94
Deficit ($ billions)					
April 1989 budget	30.5	28.0	24.4	20.6	15.0
February 1988 budget	28.6	26.3	22.9	19.5	n.a.
C.D. Howe recommendation	25.4	22.0	18.5	15.0	n.a.
Debt-to-GDP Ratio (percent)					
April 1989 budget	54.5	56.2	56.4	55.9	54.7
February 1988 budget	54.2	55.6	55.7	55.1	n.a.
C.D. Howe recommendation	53.7	54.5	54.0	53.0	n.a.

Source: Department of Finance; Statistics Canada, *National Income and Expenditure Accounts*; C.D. Howe Institute.

and revenues according to five key criteria, taking into account the need for the budget to respond to short-term constraints while keeping longer-term objectives in focus.

The Key Elements of a Sound Fiscal Plan

In advance of the April budget, the C.D. Howe Institute identified a number of elements that should be embodied in a sound fiscal strategy:[2]

- the annual deficit should be reduced to a point where the size of the public debt relative to the economy is first stabilized and then brought down below its current level by the end of the forecast period;
- this should be achieved through substantial changes — not just cosmetic adjustments — to make sure that the deficit targets are hit;
- a greater emphasis should be placed on spending restraint than on tax increases in efforts to reduce the deficit;
- the fiscal plan should be robust enough to ensure that the targets are met despite unforeseen setbacks; and
- the government should render itself accountable for its future performance on deficit reduction.

By these criteria, the recent federal budget can be termed a partial success. The growth of the public debt relative to the economy is forecast to continue to decelerate, despite an anticipated slowing of economic growth in 1990, and without much cosmetic tinkering. But an over-reliance on tax increases, and the importance of optimistic economic (and political) assumptions to the improvement in the deficit projected in the fiscal plan's "out-years" are elements that cast doubt on the government's commitment to stick with the plan in the face of adversity. Although the fiscal plan is quite complete and comprehensible, past slippages raise the question of the government's ability to deliver on its promises. Each of these points will now be addressed in turn.

Assessment of the Fiscal Plan

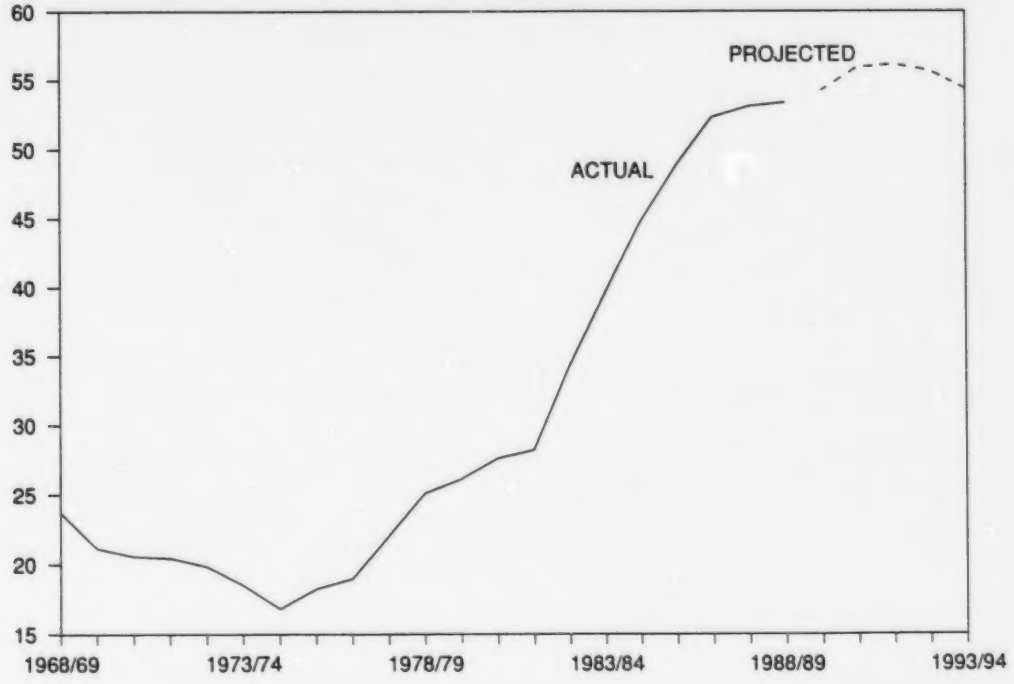
Controlling the Growth of the Public Debt

A centerpiece of a strategy that seeks to limit the importance of debt-service costs in relation to the budget and the economy is the reduction of the deficit to the point where the public debt grows more slowly than gross domestic product (GDP). This target is fre-

Figure 1

Actual and Projected Net Federal Debt as a Proportion of GDP, fiscal years 1968/69 to 1993/94

(percentage)



Sources: Department of Finance, *The Fiscal Plan* (Ottawa, April 1989); Statistics Canada, *National Income and Expenditure Accounts.*

quently expressed in terms of stabilizing the debt-to-GDP ratio.[3] In the Institute's view, an appropriate strategy would involve a reduction in the deficit to $15 billion by fiscal year 1992/93. This would produce a speedy peak in the debt-to-GDP ratio, followed by a decline to below the current level by the end of the period. Table 1 contrasts this performance for the deficit with the deficit targets contained in the April 1989 budget as well as those in the February 1988 fiscal plan. The table also shows the ratios of debt to GDP implied by these targets, using the Finance Department's April projections.[4]

The April budget proposes to reduce the deficit to $15 billion by the end of the forecast period in fiscal year 1993/94, a reduction that is expected to cause the debt-to-GDP ratio to peak in 1991/92 and then begin to decline. In this respect, the budget can be said to go part way toward meeting the criteria for a sound fiscal strategy. The growth of the debt is expected to slow to a more sustainable level. But because of the leisurely pace of the projected reduction in the deficit, the debt-to-GDP ratio is still expected to be above its current level — and twice as high as it was prior to the 1981–82 recession — by the end of the period (see Figure 1).

As a result, the government's vulnerability to interest rate changes, so vividly demonstrated in the April budget, will be still greater. By this key measure, Canada's fiscal situation is projected to have deteriorated further in five years' time, a consideration that must qualify any conclusion

Table 2

Impact of Federal Budget Measures on the Deficit, fiscal years 1989/90 and 1990/91

	1989/90 *($ billions)*	1990/91 *($ billions)*	Two-year total *($ billions)*	Proportion of total *(percent)*
Gasoline and tobacco excise tax increases	$1,255	$1,625	$2,880	20.2%
Federal sales tax changes	795	1,680	2,475	17.3
UI premium increases	425	1,900	2,325	16.3
Personal income tax changes[a]	545	950	1,495	10.5
Large corporations tax and surtax changes	410	970	1,380	9.7
Defense spending cuts	575	611	1,186	8.3
Cuts in transfers to other governments	265	505	770	5.4
Cuts in official development assistance	360	360	720	5.0
Cuts in payments to Crown corporations	108	223	331	2.3
Other tax changes[b]	265	40	305	2.1
Cuts in other subsidies and transfers	188	92	280	2.0
Savings in government operations	49	73	122	0.9
Total reduction in deficit	*5,240*	*9,029*	*14,269*	*100.0*
Subtotals				
Tax increases	3,695	7,165	10,860	76.1
Spending cuts	1,545	1,864	3,409	23.9

[a] Includes tax-back of OAS and family allowance payments.

[b] The bulk of this item is the acceleration of corporate tax payments.

Sources: Department of Finance, *The Fiscal Plan* (Ottawa, April 1989), pp. 30, 35; idem, *Budget Papers* (Ottawa, April 1989), pp. 59–61.

that the problem of the growth of the public debt has been decisively addressed.

Substantial versus Cosmetic Changes

The government has made use of a considerable array of tax and spending changes, summarized in Table 2, in its effort to hold the line on the deficit. Excise taxes and the federal sales tax have proved reliable revenue raisers in the past, and again played a prominent role in the April 1989 budget. Other tax changes — the personal surtax increase and the corporate capital tax — target a fairly stable tax base, with a revenue yield that should be relatively insensitive to economic fluctuations. The tax-back of old age security (OAS) and family allowance payments from high-income earners, despite its flaws, represents a significant step toward the better targeting of transfer payments to those in need.[5]

Also of importance to the fiscal plan in the longer term was the government's reaffirmation of its intent to implement the new goods and services tax (GST) at the beginning of 1991. The significance of the GST in efforts to control the deficit after 1991 has been increased by several developments:

- the latest increase in federal sales tax rates (since the GST yield that can be termed "revenue neutral" has risen with them);
- the scrapping of the commitment to remove personal income surtaxes when the GST is introduced; and
- the scrapping of the commitment to remove corporate surtaxes at the same time.

Once implemented, the GST is likely to become the government's favored instrument for raising additional revenues if the fiscal plan appears to be drifting off course.

The April 1989 budget deserves credit for avoiding a heavy reliance on cosmetic adjustments (such as the accelerated tax remittances featured in the 1987 tax reform package) to make near-term results look better. While this type of action has a temporary beneficial impact on the government's financing requirements, the principal effect is to produce the appearance of having achieved a target without making the fundamental adjustments needed for a lasting improvement. The April budget contained only one such measure: the acceleration of corporate tax payments, which must now actually be received, not just mailed, by their due date. As a result, the deficit figures have been improved by some $350 million in fiscal year 1989/90, a one-time effect with little significance for the underlying trends of revenues and expenditures.[6]

Although the improvement in the federal budget balance as a result of the elimination of the government's contribution to the unemployment insurance (UI) program will be larger and more durable, this change can also be criticized for avoiding a fundamental issue. It means that this portion of UI payments is now funded through UI premiums instead of general revenue. But the rationale for not funding such features of the UI program as regionally extended and fishermen's benefits from premium revenue remains as valid as ever. The income support provided by these (and other) special benefits would be more appropriately delivered outside the UI program. By shifting the burden of these payments to the payroll tax, the government has further distorted the UI system, and has reduced the fiscal incentive to reform it.

One further observation on the subject of incremental adjustments versus fundamental reforms is prompted by such tax changes as:

- the increase in personal surtaxes, which works against the principles of lower and less steeply graduated personal income tax rates that were a main feature of the 1987 tax reform, and puts Canada out of step with other OECD countries, where the trend is toward lower marginal tax rates;
- the new Large Corporations Tax, which adds another layer of complexity to the taxation of the business sector, further entrenches the dubious principle of taxation unrelated to increases in net worth, and implies either that the corporate tax system is too flawed to raise an appropriate amount of revenue from this sector or that considerations of an appropriate corporate tax burden take second place to the need for revenue;
- the reliance on the federal sales tax — described elsewhere in the budget documents as "antiquated," "damaging to the Canadian economy," and "unacceptable"[7] — for a sizable amount of additional revenue over the next two years (pending the imposition of the GST).

These measures can be seen partially as a reflection of the degree to which the growing pressure of interest payments on government revenue is overshadowing other priorities relating to the tax system, such as avoiding complexity and minimizing adverse economic effects. (The increases in the federal sales tax are less objectionable the greater one's assurance that the GST will be implemented on schedule.) But they can also be seen as incremental adjustments forced on the government by its unwillingness to undertake more fundamental measures, particularly on the spending side.

Spending Cuts versus Tax Increases

There are two broad reasons for preferring expenditure restraint over tax increases as the main focus of a deficit-reduction plan.

First, tax increases are the "soft option". In an important sense, spending cuts are the acid test of a government's resolve to pursue a more prudent fiscal course. In the short term, it is usually more politically rewarding to maintain or increase support from a well-organized, self-aware constituency than to avoid one more incremental reduction in the after-tax incomes of the general taxpaying population. For this reason, the skirting of tough spending decisions calls into question the government's commitment to fiscal balance in the face of hostility from affected groups.

Second, total public-sector outlays amounted to over 44 percent of GDP in 1988, down from the 1983 peak of almost 47 percent, but well above the prerecession level, and some 10 percentage points above the figure at the beginning of the 1970s.[8] Canada's public-sector expenditures are larger, relative to the economy, than those in its major trading partners (the United States, the United Kingdom, and Japan), a gap that is projected to increase over the next two years.[9] Raising taxes to finance this spending increases the incentive for individuals to direct their efforts toward untaxed or untaxable activities, puts a heavier burden on individuals and firms that cannot avoid taxes — with adverse consequences for Canadian competitiveness — and adds to inflationary pressure in the economy. Therefore, it seems desirable for Canadian governments in general, and the federal government in particular, to look to reducing outlays, rather than to enhancing revenues, when trying to cut back borrowing.

In the past, the C.D. Howe Institute has singled out several expenditure areas as suitable for cuts, some of which were targeted in the April budget. If the spending estimates for the current fiscal year are recalculated on the old envelope basis (which has now been abandoned, complicating historical comparisons) economic and regional development spending is projected to drop by some $2 billion, or 16 percent, from its fiscal year 1988/89 level. Cuts in previously planned levels of defense and foreign aid spending are expected to yield savings of almost $1 billion.

As visible and contentious as some of these measures may be, however, their near-term impact is considerably overshadowed by revenue measures such as the increase in the federal sales tax, higher excise levies, increases in personal and corporate surtaxes, and the imposition of a new corporate capital tax.

The Budget Breakdown

There are at least three ways of looking at the relative contributions made by expenditure and revenue changes to reductions in the deficit. The breakdown presented in the budget itself was similar to that shown in Table 2, focusing on the near term, and using projections assuming unchanged policy as a baseline.

According to the budget summary, some 29 percent of the reduction in the deficit in fiscal year 1989/90 will come from spending cuts and 71 percent from tax increases, with the corresponding figures for 1990/91 being 23 percent and 77 percent, respectively.[10]

Changes from the Previous Fiscal Plan

A more disappointing longer-term picture emerges from a comparison of the fiscal plan presented with the April budget with that contained in the February 1988 budget, as shown in Table 3. Aggregate program spending, like the deficit itself, is now projected to be higher than forecast in the previous budget. Moreover, despite the fact that unexpectedly large increases in debt-service costs have been cited as the principal reason for missing the old deficit targets, increases in the projected levels of debt-service charges in fiscal years 1991/92 and 1992/93 account for only one-third of the total increase in spend-

Table 3

The Federal Government's Fiscal Projections for fiscal years 1989/90 to 1992/93

($ billions)

	1989/90	1990/91	1991/92	1992/93
Program spending				
February 1988 Fiscal Plan	101.9	105.8	108.9	112.4
April 1989 Fiscal Plan	103.5	109.0	115.5	118.3
Increase	1.6	3.2	6.6	5.9
Debt-service charges				
February 1988 Fiscal Plan	33.0	33.5	34.6	35.4
April 1989 Fiscal Plan	39.4	39.8	37.4	39.3
Increase	6.4	6.3	2.8	3.9
Total spending				
February 1988 Fiscal Plan	134.9	139.3	143.5	147.8
April 1989 Fiscal Plan	142.9	148.8	152.9	157.6
Increase	8.0	9.5	9.4	9.8
Revenue				
February 1988 Fiscal Plan	106.3	113.1	120.6	128.3
April 1989 Fiscal Plan	112.4	120.8	128.5	137.0
Increase	6.1	7.7	7.9	8.7
Deficit				
February 1988 Fiscal Plan	28.6	26.3	22.9	19.5
April 1989 Fiscal Plan	30.5	28.0	24.4	20.6
Increase	1.9	1.7	1.5	1.1

Sources: Department of Finance, *The Fiscal Plan* (Ottawa, February 1988); idem, *The Fiscal Plan* (Ottawa, April 1989); and idem, unpublished data.

ing. Higher levels of program spending account for the rest.

It is not difficult to find examples in the *1989/90 Estimates* of spending increases that seem inappropriate in light of the size of the fiscal imbalance. The most striking feature of federal spending emerging from a comparison of the two most recent fiscal plans, however, is the degree to which the increased level of program spending is automatic, stemming from a higher level of current-dollar GDP than was forecast in February 1988.[11] About one-fifth of federal non-interest expenditure — mostly transfers to other levels of government — is positively linked by formulas to the level of spending in the economy. This means that stronger economic growth tends to translate, not into the lower outlays that might be expected, but into higher levels of expenditure.[12]

The fact that much of the new higher level of program expenditure is not the result of deliberate choices in the April budget does not mean that it should be disregarded. The perverse phenomenon whereby higher levels of economic activity tend to produce automatic increases in large components of federal spending is not only questionable stabilization policy, but also an important contributor to current federal fiscal difficulties, since it limits the tendency of healthy economic growth to strengthen the budget balance.

Past budgets have attempted to slow the growth of some of these expenditures by scaling back the indexation factors, as with Es-

Table 4

Contributions to Deficit Reduction, fiscal years 1984/85 to 1993/94
(percentage of GDP)

	1984/85 to 1988/89	1988/89 to 1990/91	1990/91 to 1993/94	1988/89 to 1993/94
Lower program spending	2.8%	0.6%	1.0%	1.5%
Higher revenues[a]	1.5	0.7	0.5	1.2
Lower net debt-service charges	-0.5	-0.6	0.9	0.3
Reduction in deficit	*3.8*	*0.7*	*2.3*	*2.9*

Note: A positive number indicates that a change in a given item acted to reduce the deficit. Numbers may not add due to rounding.

[a] Excluding return on investments (included in net debt-service charges).

Source: Calculated from data in Department of Finance, *The Fiscal Plan* (Ottawa, April 1989); idem, unpublished data; and Statistics Canada, *National Income and Expenditure Accounts*.

tablished Programs Financing (EPF) transfers to the provinces. The April 1989 budget further reduced the indexation of EPF transfers by one percentage point, beginning in fiscal year 1990/91. While this move alleviates some automatic upward pressure on federal spending, it is open to objection on other grounds. It is not clear that repeated unilateral changes to the agreed formula for EPF financing on the part of the federal government are an appropriate approach to federal-provincial fiscal transfers in an era of federal budget restraint. What appears to be needed here is a major rethinking of this aspect of intergovernmental transfers — a subject that lies outside the scope of this *Monitor*.

Spending and Revenues Relative to GDP

Perhaps the best way of assessing the relative contributions of spending cuts and tax increases is to remove some of the difficulties imposed by the choice of baselines and by inflation in evaluating dollar figures, and to control for the influence of larger-than-expected GDP on various items by examining changes in the various major budgetary items as proportions of GDP. This is done in Table 4, which shows the respective contributions of program expenditure cuts, revenue (excluding investment income) increases, and changes in net debt-service costs to the total reduction in the deficit as a percentage of GDP over the past four fiscal years, and as projected for the next five. (The forecast periods 1988/89 to 1990/91, and 1990/91 to 1993/94, are shown separately.)

During the government's first term, the deficit was reduced from 8.6 percent to 4.8 percent of GDP. The bulk of this reduction was achieved through cuts in program spending. Meanwhile, however, a rise in net debt charges meant that revenue increases equal to 1.5 percent of GDP were needed to bring about the reduction in the deficit.

Measured in this way, the balance between spending cuts and tax increases anticipated over the next five years is better, but still somewhat unsatisfactory. Over the entire period, the deficit is expected to decline by 2.9 percentage points relative to GDP. Cuts in program spending are projected to account for roughly half the total cut in the deficit, while federal revenues are expected to increase by 1.2 percentage points of GDP — two-fifths of the deficit reduction.

Spending cuts are thus expected to edge out revenue hikes in their contribution to

deficit reduction over the forecast period. It is, however, disappointing that at the beginning of its second term of office, the government is projecting a fiscal plan that — both in terms of the overall reduction in the deficit, and in terms of the contribution to be made by spending cuts — is less ambitious than what was actually achieved (let alone projected) in its first term.

It is also disturbing to note that the bulk of the reductions in spending (as a proportion of GDP) are left until later in the period, with tax increases playing a relatively greater near-term role. The political, legal, and administrative reasons for this situation are not hard to imagine, but confidence in the fiscal plan has to be undermined by the fact that bigger spending cuts are not being undertaken at the beginning of the government's mandate, when the political will to proceed with them can be assumed to be greater.

The remainder of the reduction in the deficit between fiscal years 1988/89 and 1993/94 is expected to arise from declining debt-service costs. These lower interest payments do not come about because of a lower level of debt relative to GDP — as was pointed out earlier, the debt-to-GDP ratio is expected to be *higher* at the end of the period than in 1988/89 — but as a result of dramatically lower interest rates, which raises the issue of the importance of economic circumstances to the fiscal plan's realization.

What Are the Risks to the Fiscal Plan?

Any assessment of the deficit projections contained in the fiscal plan has to involve a look at their sensitivity to adverse developments. Collapses in the prices of oil and grain, and rising interest rates, have played key roles in the derailing of earlier projections, and the possibility of further sectoral crises or a general economic slowdown is always present.

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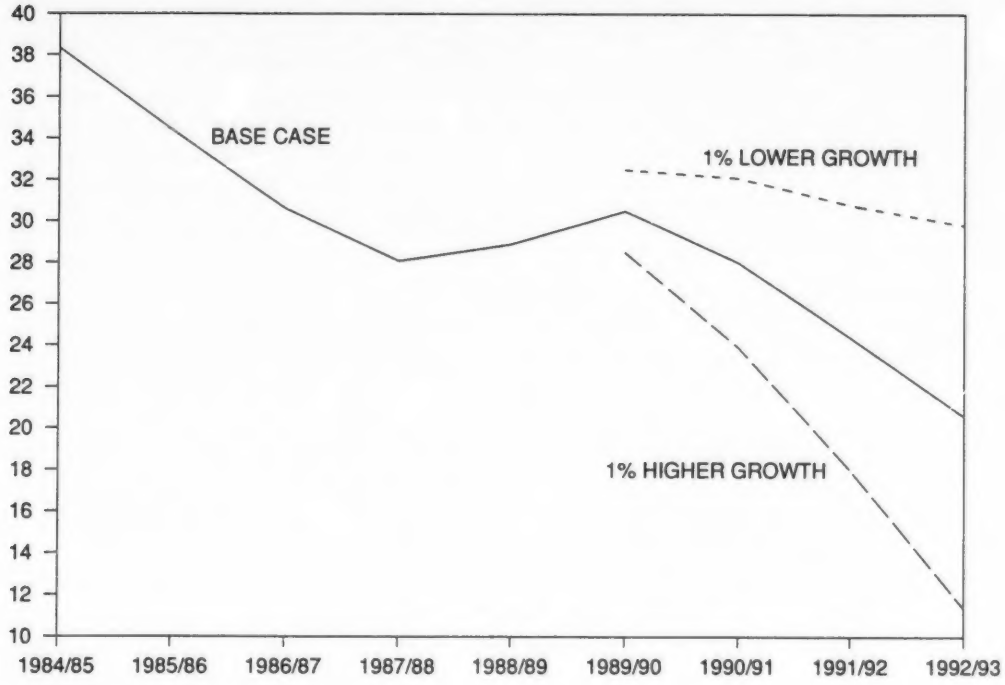
The ability of people outside the Department of Finance to estimate the potential effects of unexpected deviations in economic growth and interest rates on the budget has been enhanced by the inclusion, beginning with the May 1985 budget and continuing in the February 1988 and April 1989 budgets, of sensitivity tables in the fiscal plans. These tables provide useful rough estimates of the impact of different economic circumstances on the deficit. Unfortunately, the tables included in the two most recent budgets exclude changes in the balance of the UI Account from their calculations. The rationale for this exclusion is that the account is required to balance over relatively short periods of time, as a result of regular adjustments to premium rates which are partially discretionary and therefore problematic to predict in advance.

In practice, however, the UI Account has tended to vary substantially from balance in recent years — from the end of 1982 to the end of 1988, the net improvement in the annual balance of the account was about $5.5

Figure 2

GDP Growth and the Deficit, Various Scenarios, fiscal years 1984/85 to 1992/93

($ billions)



Note: The alternative paths for the deficit shown in this chart are calculated by adjusting the budget projections by the amounts indicated in Table A.6.1 of the *Fiscal Plan*, and adding estimates of changes resulting from the operations of the UI Account, using assumptions about the relationship between GDP and employment growth similar to those underlying Table A.6.1. In the base case, employment growth averages 1.6 percent annually from 1989 to 1992, and the average unemployment rate over the period is 8 percent. The higher-growth scenario assumes employment growth averaging 2.1 percent annually and an average unemployment rate of 7.2 percent, while the lower-growth figures are 1.1 percent and 8.8 percent respectively.

billion. Moreover, the exclusion of the account from the April budget was particularly inappropriate, since UI premium rates are currently projected to remain unchanged for the years 1990 to 1992, and the automatic balancing adjustments on the revenue side are therefore not expected to operate during that period. The UI Account is one of the elements of the budget that is most sensitive to cyclical fluctuations, and its omission from the sensitivity projections considerably reduces their usefulness.

A rough picture of the sensitivity of the deficit to economic growth over the next four years, with the UI Account added back in, is presented in Figure 2. It is necessary to be cautious about these figures, since they are based on "rule-of-thumb" estimates of the impact of key variables on the budget, and do not incorporate dynamic effects, such as the impact of higher growth or changes in the government's fiscal position on inflation and interest rates. Nevertheless, the picture they give of the importance of economic performance to the budget outcomes is instructive.

In the (rather unlikely) event that annual economic growth is one percent higher than projected in the budget over the next four

years, the cumulative reduction in the deficit could, on these estimates, exceed $20 billion. The effect on the debt-to-GDP ratio would be even more dramatic. The simultaneous effects of slower debt accumulation and faster GDP growth could reduce the ratio by almost 5 percentage points from the base case level by the end of fiscal year 1992/93. If, on the other hand, GDP growth averaged one percent per year lower than projected, the outcome is correspondingly more dismal. The deficit in 1992/93 would be virtually unchanged from its current level, and the debt-to-GDP ratio would have risen to over 60 percent.[13]

Bearing in mind the importance of the economic forecast to the fiscal plan, the near-term economic projections within which the April budget's targets are set appear quite conservative. The projected deceleration in GDP growth to 1.7 percent in 1990 and the associated slowing of employment growth to 0.7 percent are certainly more pessimistic than is usual in government projections. On the interest-rate front, recent developments and the views of most forecasters suggest that, in the near term, surprises are more likely to be pleasant than otherwise. Looking further out, however, there appear to be three key threats to the realization of the fiscal plan's targets.

First, the interest-rate projections — which, given the size of the federal debt, have become a critical component of the forecast — are crucial to the anticipated reductions in the deficit. According to the sensitivity tables, a one percent increase in interest rates would add $1.6 billion to the deficit in the first year (equal to the total of all spending cuts for fiscal year 1989/90 included in the April budget).[14] If the government's effective debt-servicing rate on the entire net public debt were to stay at the level projected for 1989/90 throughout the forecast period, even a path for the primary balance[15] along the lines laid out in the fiscal plan would produce a total deficit of some $26 billion in 1993/94.

Second, the growth projections for the years following 1990 — real GDP growth averaging 3.2 percent annually; employment increases averaging 2.1 percent annually — appear quite optimistic relative to recent historical experience, especially since the expansion will be a decade old by the end of the period. The prospect of a prolonged period of slower growth resulting from a slowdown in the United States or other international setbacks has not been given enough weight in the forecast.

Finally, the budget has put off the most rapid reductions in the deficit to the final three years of the plan. If the favorable economic circumstances envisaged in those years do not materialize, it is questionable whether the government will stick to its targets. The principal evidence in this regard is the government's ability to stick with previous fiscal plans. Despite the fact that Canada's economic performance since 1986 has been consistently better, and tax revenues generally more buoyant, than expected, the government's deficit targets have tended to ratchet up over time (see Figure 3), with the result that the period during which the debt-to-GDP ratio is scheduled to stabilize has continually been pushed further into the future.

The Question of Accountability

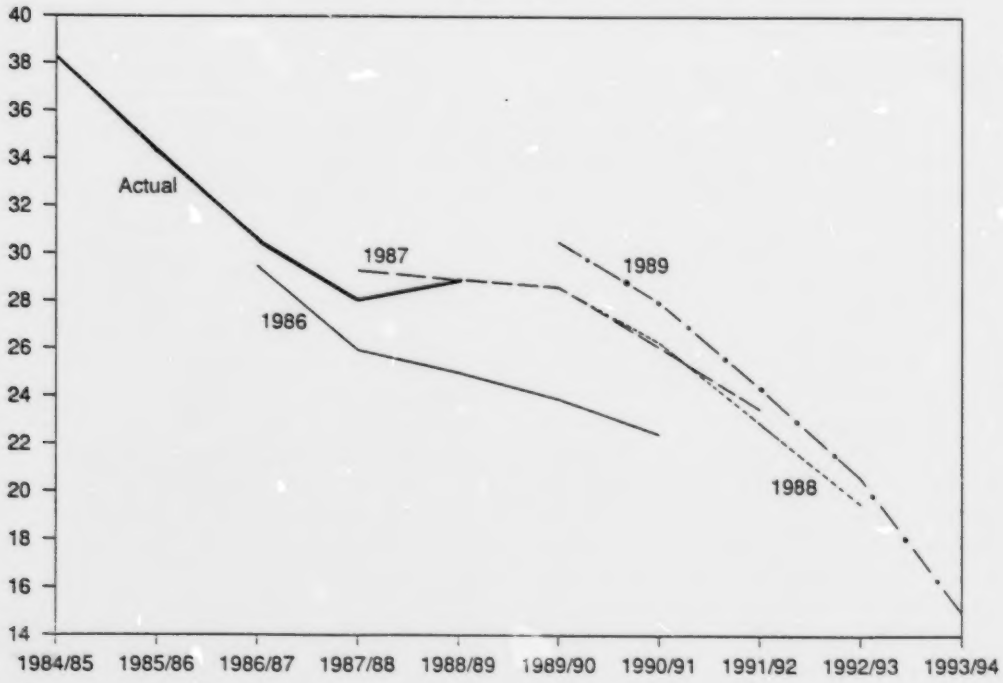
The federal government's ability — or lack of it — to stick with its projections raises the key question of accountability. A government's accountability for its actions is fundamental to representative democracy. It requires that governments identify their goals clearly, and make themselves answerable to voters for their success or failure in living up to those goals.

Generally speaking, recent federal budgets — the April 1989 budget included — have set a high standard in terms of disclosing objectives and methods, and providing

Figure 3

Various Federal Government Deficit Projections, fiscal years 1984/85 to 1993/94

($billions)



Source: Department of Finance, various issues of *The Fiscal Plan*.

the information needed to compare the proposed plan with past performance as well as with future outcomes. The job of fiscal policy watchers has been complicated somewhat this time by the loss of some historical continuity stemming from the abolition of the old envelope system, and is again hampered by the exclusion of the UI account from the sensitivity tables.

A disappointing feature of the April budget, as far as accountability is concerned, is the fact that — despite the budget's emphasis on interest on past borrowing as the main factor pushing the old fiscal plan off course — there was no attempt to relate any of the tax increases specifically to deficit reduction.[16] This absence highlights the fact that, in dollar terms, much of the additional revenue is financing higher levels of program spending, while the budgetary shortfall has been allowed to widen.

In large part, the question of accountability is one that can only be answered in retrospect. It is obviously too early to make a definitive judgment about how the April 1989 fiscal plan will appear from the vantage point of 1993. But it is notable that, along with particular details such as the fourth straight postponement of the scheduled increase in RRSP contribution limits, this budget marks another significant abandonment of previous fiscal targets. Previous slippage and the government's unwillingness to make more substantial spending cuts make the realization of the new fiscal targets questionable.

The question of accountability cannot be dodged by pointing to the unexpected impact

of higher interest rates on the debt-service burden. The size of the increase in interest payments this year may have come as a surprise. But the fact that the growing public debt was causing interest costs to loom ever larger in total expenditures, and increasing the government's vulnerability to interest rate changes, has been the subject of concerned commentary — both inside and outside the Department of Finance — for years. On balance, the economic environment since 1984 has been favorable for deficit reduction. If the government had taken advantage of favorable circumstances to meet (or, better, to exceed) its earlier deficit targets, the present situation would be less serious.

During the next five years, it will be important for the government to keep its fiscal objectives in the public eye. With a consistent public education campaign, and an attempt to make sure that future changes to federal revenues and expenditures are explained in relation to the fiscal challenge, it should be possible to keep this issue on the front burner. But statements of intent are only a part of the package — action consistent with those statements is essential.

The Next Five Years

The Size of the Task

Before attempting to sum up the outlook for federal fiscal policy in the aftermath of the budget, it is worth recalling that the size of the government's task in righting the fiscal imbalance has grown along with the size of the debt. The magnitude of the adjustment in federal fiscal policy that is envisaged from the beginning of the Conservative government's first term of office in fiscal year 1984/85 to the end of the fiscal plan's forecast in 1993/94 is evident in Figure 4, which shows the primary balance as a proportion of GDP in relation to the business cycle.

The size of the forecast shift in the primary balance is considerable: having moved (with the help of a strong cyclical rebound) from a deficit of $20.1 billion in 1984/85 to a deficit of $1.3 billion in 1988/89, the primary balance is projected to move by a comparable dollar amount — to a surplus of $20 billion — by 1993/94. The cumulative adjustment envisaged over the entire nine-year period would be unlike anything Canada has experienced over the past 30 years. Unfortunately, however, tardiness in bringing about this adjustment means that, with the net public debt forecast to reach $440 billion by the end of the period, the burden of interest payments will keep the total budget balance well in deficit.

At the same time, the burden of interest payments has caused the normal relationship between the primary balance and the business cycle, evident during the 1950s, 1960s, and early 1980s, to break down completely. The potential economic stabilizing effect of the government's non-interest budgetary transactions has been largely disabled, for the foreseeable future, by the debt-servicing problem.

Staying on Course

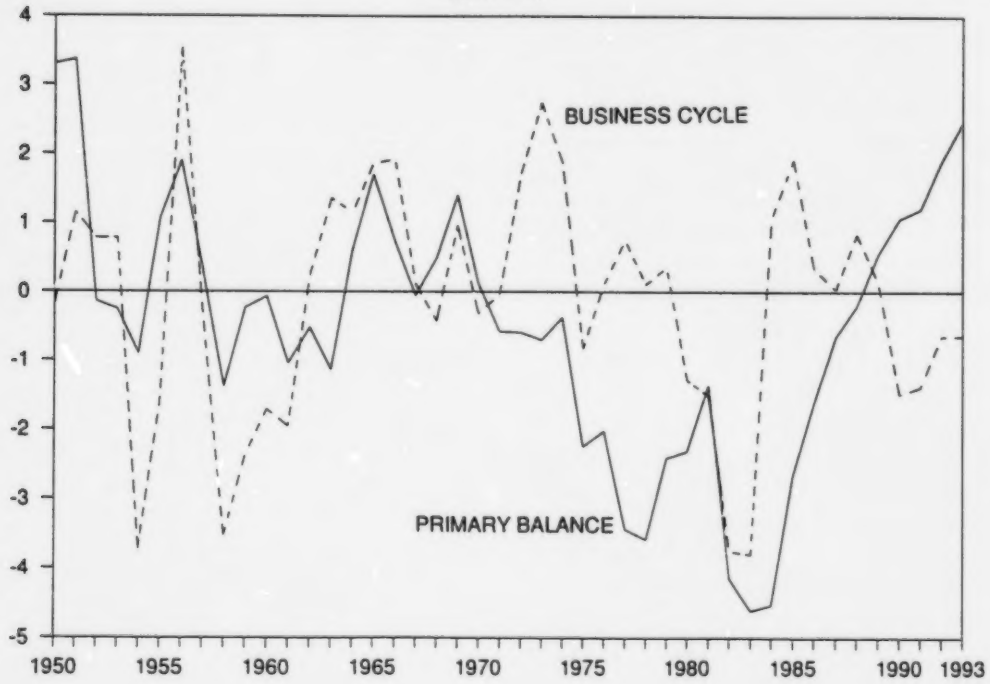
The fact that the pressure of interest payments has come to be such a decisive factor in federal budget planning is the clearest possible indication that the public debt has grown too large and must be contained. The April 1989 budget puts this issue at the forefront, and proposes to slow the growth of the debt to a sustainable rate — albeit at a somewhat leisurely pace. The contribution of cosmetic adjustments to the process is quite minor.

There are a number of indications, however, that it is too early for those concerned with Canada's fiscal position to relax. The government has been too ready to impose tax increases, and has not put non-interest expenditures under pressure proportional to the seriousness of the debt problem. Moreover, a large part of the improvement in the deficit is projected to come

Figure 4

The Business Cycle and the Primary Balance, 1950–93

(percent)



Note: The business cycle is represented by deviations in the growth rate of real GDP per person, measured over two-year spans, from its trend since 1950. The primary balance is expressed as a proportion of GDP.

Source: C.D. Howe Institute calculations, based on data from the Department of Finance and Statistics Canada, *National Income and Expenditure Accounts*.

in the more distant future, aided by buoyant economic growth and low interest rates, and unaffected by the prospect of a coming election.

The government has laid out a comprehensive fiscal plan. Past plans have not, however, proved entirely reliable guides to performance. Canadians who are concerned about the consequences of chronic large-scale government borrowing must be vigilant in holding the government to its stated objectives. In addition, they must demand that the government seize favorable opportunities to accelerate the process of redressing the fiscal imbalance, and hasten the day when the pressure of interest payments is no longer the chief consideration in setting federal fiscal policy.

Notes

1. These effects were discussed in Neil Bruce and Douglas D. Purvis, *Evaluating the Deficit: The Case for Budget Cuts*, Policy Commentary 4 (Toronto: C.D. Howe Institute, 1984), pp. 8-10; and Maureen Farrow and William B.P. Robson, *Building a Constituency for Deficit Reduction*, Fiscal Policy Monitor 1 (Toronto: C.D. Howe Institute, 1989), pp. 8-13.
2. Ibid.
3. The debt-to-GDP ratio compares the size of the net public debt — the sum of all the federal deficits, less surpluses, ever run — at the end of a fiscal year to the size of GDP during the overlapping calendar year. For example, the net public debt at the end of fiscal year 1988/89 is estimated at $321.1 billion, while 1988 GDP was $601.5 billion, yielding a debt-to-GDP ratio of 53.4 percent.
4. Since the April budget, Statistics Canada has released new estimates of GDP from 1985 through 1988. For the sake of consistency with the Department of Finance's forecast, comparisons of budgetary figures to GDP in this *Monitor* are made with reference to the old figures.
5. Improved targeting of these payments by means of a tax-back mechanism has been advocated in previous C.D. Howe Institute publications. See, for example, Edward A. Carmichael, *Tackling the Federal Deficit*, Observation 26 (Toronto: C.D. Howe Institute, 1984), pp. 39, 41.
6. The switch to annual reporting of certain types of accrued investment income is also expected to produce a largely temporary increase in personal tax revenue of some $200 million in 1991 and $300 million in 1992.
7. Department of Finance, *The Goods and Services Tax* (Ottawa, 1989), pp. 3–8.
8. National accounts basis. Federal outlays, at 21.8 percent of GDP in 1988, accounted for a little less than half the total.
9. Department of Finance, *The Fiscal Plan* (Ottawa, 1989), Table A.3.2.
10. Ibid., pp. 30, 35. The figures for 1990/91 included the tax-back of old age security and family allowance benefits as spending cuts rather than tax increases. If these amounts had been shown on the revenue side instead, as in Table 2, the proportions would have been 21 percent and 79 percent, respectively, in that year.
11. The higher levels of nominal GDP arise from the fact that real growth in 1987 and 1988 was stronger than was estimated in February 1988, while inflation in 1988 also turned out to be higher than forecast. The April 1989 budget forecasts slightly lower increases in nominal GDP for the 1989–92 period than the previous budget (a 6.2 percent average annual increase as against the old forecast of 6.5 percent), but the higher base from which the projections are made yields a higher level of nominal GDP throughout the forecast.
12. This effect is even more pronounced when one takes into account the influence of interest rates, which tend to be higher when growth of nominal output is stronger, on debt-service costs.
13. It is unlikely that UI premium rates would, in fact, remain unchanged under such a scenario, given the large cumulative deficit that would emerge in the UI Account. The premium rates set for the years 1990–92 are already expected to result in a sizable shortfall in the account during that period under the economic assumptions of the fiscal plan. If Canada's economic performance turned out to be worse than expected, it is likely that part of the impact would be reflected in an increase in UI premiums from their projected level (in other words, higher taxes) rather than entirely in a larger budgetary deficit.
14. Department of Finance, *The Fiscal Plan*, Table A.6.2.
15. The primary balance is the total budget balance excluding net public debt charges — that is, revenues less return on investments, minus expenditures less public debt charges. The primary balance reveals the path of federal fiscal policy excluding the large, nondiscretionary debt-service component.
16. The fact that the increases in personal income taxes took the form of surtax increases rather than general rate increases suggests that they might be regarded as a temporary response to the current fiscal shortfall. It should be noted, however, that the "temporary" surtaxes imposed in the May 1985 budget have proved to be quite durable.

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